

## The Warning-Light of Automobile Securitisation: Credit Rating Agencies and Their Role in a post-2016 World

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*With 2016 providing arguably the most politically tumultuous year in recent history, the need for vigilance in the marketplace has never been greater. The proximity to the recent Financial Crisis means that any undeserved leniency now may have dramatic and irreversible effects. In this short article, the focus will be on the opportunity that the rise in automobile-securitisation is offering the Credit Rating Agencies to transgress like in the 2000s. The article will discuss the dramatic rise in personal financing and the subsequent securitisation and will ultimately suggest that action needs to be taken sooner rather than later, with the abiding caveat being that there must be a political appetite to do this – whether or not this appetite exists will be discussed.*

Although it will be far beyond this short article to explain and debate the actual process of securitisation, it will be good to start with just a simple understanding, and then follow that up with a description of the process’ effect upon modern society. The article aims to show that automobile loan-backed securitisation (hereafter auto loan securitisation) is not only on the rise, but is presenting a real opportunity for Credit Rating Agencies to transgress, in a manner similar to that which had a pivotal influence upon the Financial Crisis of 2007/08. However, before that, a simple explanation of the securitisation process will be necessary to shape the argument that follows.

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Simply put, asset *securitisation* describes the process where a number of loans, of any type, are placed together in a ‘pool’ – the ability to then purchase a stake in this pool, and thus receive a proportion of the overall collection of payments made on the original loans, is then offered to investors. How much an investor receives, and when, will be determined by the ‘tranche’ (French for ‘slice’) in which they invest, with each tranche having different characteristics<sup>1</sup>. Now, for our understanding, two elements are important to explain here. Firstly, the *loan* that can be securitised has no definition – as long as there exists a schedule of future and supposedly consistent payments, the loan can be securitised. This is important because although residential mortgages dominated the headlines due to the financial sector’s general fervour for their trade, there are a number of other options that can, and indeed do get securitised. For example, after the market crashed for *residential* mortgage-backed securities, a new market for *commercial* mortgage-backed securities developed, and was exploited in exactly the same way<sup>2</sup>. So, based on this, we can understand that auto loan securities can similarly be developed – the major difference being the time it takes to reach maturity on a auto loan compared to a property mortgage. Secondly, *how* those tranches are differentiated is of real importance to our understanding, because essentially it is dependent upon the rating that credit rating agencies give to each tranche<sup>3</sup>. There are a few factors which should be mentioned, namely that investors are usually restricted, whether by regulatory or internal rules, to which tranche they can invest in, primarily because of what each tranche offers – large investors, which must be conservative due to the potential for systemic failure if they are not, are usually restricted to the ‘senior categories’ which are rated AAA, the agencies’ highest rating (terminologies can differ) – this means that although the returns are smaller, they are guaranteed more of their money back if the security fails, which is in contrast to the lowest tranche, the equity tranche, which carries huge risk (one is very unlikely to see their

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<sup>1</sup> For just one representative piece of literature in this field see John Deacon *Global Securitisation and CDOs* (John Wiley & Sons 2004).

<sup>2</sup> The SEC punished Standard & Poor’s for conspiring against investors in this particular market in 2015. The report explains the transgression, but also the concept of commercial mortgage-backed securities; see Securities and Exchange Commission *Order Instituting Administrative and Cease-and-Desist Proceedings, Pursuant to Section 8A of the Securities Act of 1933 and Sections 15E (d) and 21C of the Securities Exchange Act of 1934, Making Findings, and Imposing Remedial Sanctions and a Cease-and-Desist Order* [2015] Release No. 9705; 74104, File No. 3-16348.

<sup>3</sup> For a discussion on the importance of rating agencies to the process of securitisation see Frank J Fabozzi, Anand K Bhattacharya, William S Berliner *Mortgage-Backed Securities: Products, Structuring, and Analytical Techniques* (John Wiley & Sons 2010); Marco Pagano and Paulo Volpin ‘Credit Ratings Failures: Causes and Policy Options’ [2010] 25 *Economic Policy* 62.

money returned if the security fails) but is incentivised by large returns – a staple for hedge-funds, for example.

To digress for one moment, it is worth noting that the actual *process* of securitising loans is not in itself negative – it is the abuse of the system that is distasteful. The system of securitising assets can be extremely beneficial to a number of parties, as has been widely recognised in the literature. Choudry discusses how, for the issuing party (usually a bank), securitisation offers a ‘double benefit’ in that the assets that are sold to investors generate a saving via the reduced need for capital requirements, as the assets are no longer on the balance sheets of the banks once they have been securitised and transferred to the investors<sup>4</sup>. Secondly, dependent upon the credit rating of the issuing bank, the bank may see a reduction in its funding costs if it issuing securities that are rated higher than it is<sup>5</sup>. For investors, the appeal lays in the understanding that investing in asset-backed securities can help diversify their interests, and sectors of interests, access sectors that may not usually be open to them, and also to be able to tailor your risk-return portfolio, which is of increasing importance in an increasingly complex marketplace<sup>6</sup>. It has also been argued, in terms of the mortgage-backed securities market specifically, that securitisation benefits all parties such as mortgage borrowers, capital market investors, and lending and securitising agencies, because a competitive lending market lowers the price for all participants<sup>7</sup>. The process clearly has a lot of value, but the impact of abuse is of paramount importance to this piece, and that abuse can only really have an effect upon the economy moreover if the credit rating agencies facilitate it. Therefore, it will be worth taking a closer look at their role, and the growing market for auto loan securities more specifically

Now we know the process, it is worth looking at the development of the auto loan security market to do two things: firstly to show the opportunity in reality, and then secondly to shape this opportunity in the abstract and relate it to the politically volatile era that 2016 ushered in, complete with its fertile ground for financial deregulation. This will be important to

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<sup>4</sup> Moorad Choudry *Bank Asset and Liability Management: Strategy, Trading, Analysis* (John Wiley & Sons 2011) 297.

<sup>5</sup> *ibid.*

<sup>6</sup> Moorad Choudry *An Introduction to Bond Markets* (John Wiley & Sons 2010) 236.

<sup>7</sup> David Leece *Economics of the Mortgage Market: Perspectives on Household Decision Making* (John Wiley & Sons 2008) 15.

contextualise the claim made by this piece - that this growing market for auto loan securities, when combined with an understanding that political movements are arguably prioritising deregulation, means that there is a perfect storm of factors accumulating – because this may allow the credit rating agencies to transgress like they did before the last financial crisis. Firstly, however, it is important that we understand the intricacies of the auto loan securities market, to better understand the relevance of it and the potential size of the problem if it leads to a bubble – clearly any failing in this market will not be as large as the mortgage-backed boom, but it still may be significant enough to cause a widespread downturn. The auto loan securities market is made up of securities that contain a number of variants of auto loans, including secured loans, hire purchases, and financial leases<sup>8</sup>. The quality of these loans and the subsequent securities that are created is determined by the processes of the financier, as it has been noted that, generally, vehicle financing companies outsource the investigative stage of proceedings to outside companies, and they then utilise that information to underwrite the loan<sup>9</sup>. However, there are issues with the process. There can be problems emanating from this process described above – known as the securitisations stemming from ‘captive finance subsidiaries of manufacturers’ – as the manufacturers will have an incentive to sell the vehicle and will offer incentives like 0% financing to secure the sale, leading to a reduced output to be entered into the securitisation process<sup>10</sup>. Also, there are more abstract concerns because, as one scholar notes, the institutions responsible for origination do not own any equity shares and therefore are more interested in volume than in quality control<sup>11</sup>. This was witnessed in the mortgage-backed markets before 2007, and the relatively rapid increase in the auto loan securities market hints at a similar scenario.

Auto loan securitisation has nearly always existed as long as securitisation as a tool has<sup>12</sup>, but recent reports suggest that financial product is growing increasingly popular. Part of this can

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<sup>8</sup> Vinod Kothari *Securitization: The Financial Instrument of the Future* (John Wiley & Sons 2006) 402.

<sup>9</sup> *ibid* 403.

<sup>10</sup> Ralf Hesdahl and Stuart Litwin ‘Auto loans and lease ABS’ in Rick Watson and Jeremy Carter *Asset Securitisation and Synthetic Structures: Innovations in the European Credit Markets* (Euromoney Books 2006) 172.

<sup>11</sup> Doris Köhn *Mobilising Capital for Emerging Markets: What Can Structured Finance Contribute?* (Springer 2011) 17. It is for these reasons that the Financial Conduct Authority has initiated investigations into the conduct of these institutions, see Ben Marlow ‘Mis-sold car finance could be the next PPI scandal’ [2017] *The Telegraph* (May, 6.).

<sup>12</sup> The Securities Industry and Financial Markets Association note that as of the beginning of their records in 1985, auto loan securities have made up a fairly sizable proportion of their records, the 2000s notwithstanding. For more see The Securities Industry and Financial Markets Authority *Statistics: US ABS Issuance and Outstanding (1985 to 2016)* (SIFMA 2016).

be traced to the moves by the large American-based auto companies like Ford, General Motors and DaimlerChrysler to increase their presence in the auto loan securities market in response to the lowering of their credit ratings in the early 2000s, because the drop in ratings increased the costs for these companies to raise funds directly from the capital markets themselves<sup>13</sup>. Moving on to after the Crisis, the Financial Times reported in 2015 that auto loan securitisation was set to hit record levels in Europe, nearing €20 billion<sup>14</sup>, whilst in the U.K. it was reported that the rate was set to beat Europe's entire auto-based borrowing and conclude at £31.6 billion for 2016 alone<sup>15</sup>. Yet, whilst one may not see this rise as particularly worrying – in fact, one may see it as a sign of a recovering economy – it is being witnessed alongside an element that is a fundamental ingredient for financial crisis, and that is abuse. In 2015, the U.S. Department of Justice was already investigating this area of securitisation for possible instances of fraud – the exact same issues that blighted mortgage-backed fraud i.e. the increased availability to people with poor credit scores, and an increased competition in the marketplace which is facilitating predatory lending (the Financial Conduct Authority in the U.K. is conducting similar investigations)<sup>16</sup>. In fact, a number of concerned onlookers have already suggested that investors are again not aware of what lies behind the credit ratings afforded to auto loan securities and their tranches<sup>17</sup>. Furthermore, it has been reported that delinquencies on U.S. auto loans are at a record high<sup>18</sup>, which should obviously lead to concern in light of the ethical standpoints of those peddling this increased finance to people who cannot afford it in the long-run. Yet, that warning is not being heeded, as more and more people enter into this ever-growing marketplace buoyed by the perceived bonanza that is brand-new cars for very little money – in the U.S. last year, the total amount of loans *outstanding* on auto loans rose to \$1.1 trillion<sup>19</sup>. Whilst people continue to be lured by cheap finance into what is, effectively at this point, a Ponzi-like scheme, there are no shortage of

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<sup>13</sup> Kothari (n 8).

<sup>14</sup> Thomas Hale 'Securitisation with car loans set to hit record in Europe' [2015] Financial Times (June 25) <https://www.ft.com/content/65fdc3a0-1a91-11e5-8201-cbdb03d71480>.

<sup>15</sup> Patrick Collinson 'Sub-prime cares: are care loans driving us towards the next financial crash?' [2017] Guardian (Feb 10) <https://www.theguardian.com/money/2017/feb/10/are-car-loans-driving-us-towards-the-next-financial-crash>.

<sup>16</sup> David McLaughlin, Tom Schoenberg, and Matt Robinson 'Auto Loan Securitisation Probed by U.S., States, Yates Says' [2015] Bloomberg (Feb 24) <https://www.bloomberg.com/news/articles/2015-02-24/justice-department-probing-auto-loan-securitization-yates-says>; Marlow (n 11).

<sup>17</sup> Matt Robinson, Sarah Mulholland, and Jody Shenn 'What Lurks in Bonds Tied to Subprime Autos Anyone's Guess' [2014] Bloomberg (Oct 2) <https://www.bloomberg.com/news/articles/2014-10-01/what-lurks-in-bonds-tied-to-subprime-autos-anyone-s-guess>.

<sup>18</sup> Tracy Alloway 'This is what's going on beneath the subprime auto-loan turmoil' [2016] Bloomberg (Mar 21) <https://www.bloomberg.com/news/articles/2016-03-21/this-is-what-s-going-on-beneath-the-subprime-auto-loan-turmoil>.

<sup>19</sup> Collinson (n 10).

takers for their peddlers – in a recent offering to investors of £1.3 billion’s worth of securitised U.K. auto loans, on behalf of Peugeot, none other than HSBC, Lloyds, Wells-Fargo, and BNP Paribas, took part in the sale<sup>20</sup> – there is clearly no sense of Deja-vu in the offices of the financial elite.

Whilst there may not be any sense of Deja-vu in the offices of the financial elite, it should not really be of great surprise. Although it would be optimal for these institutions to be mindful of their impact upon society, they exist primarily to serve themselves, and this must be remembered. Rather than understanding that their transgressions filter through to every part of society, these organisations have realised that if their influence is wide-enough, they *will* be rescued by the Government with taxpayer resources. So, with this in mind, it is vitally important that regulators do not develop this amnesia, particularly with regards to the securitisation process and the role of the rating agencies. There is enough evidence *now* to suggest that credit ratings given to auto loan securities should be thoroughly investigated *formally*, but if we consider the actions of the agencies before, during, and indeed after the financial crisis, then this investigation *has* to happen to prevent another financial failure. This is, arguably, hard to disagree with – it would take the staunchest pro-market analyst to find fault with this logic, simply because of the consistency of the rating agencies’ transgressions, transgressions which the agencies have recently admitted to and been punished ‘accordingly’<sup>21</sup>. Yet, 2016 should create huge doubt in our minds as to the likelihood of such an investigation taking place, and two particular instances come to mind.

Firstly, in June 2016, the U.K. electorate voted to leave the European Union. The debate about this, and the potential outcome for a number of areas has been debated since before the referendum, and will no doubt continue to do so. However, what this means is that there is a distinct risk that in order to garner increased income in the wake of leaving the economic bloc, the U.K. Government will relax its regulatory stance in order to be perceived as ‘business-friendly’, a sentiment which the U.K.’s current political elite is keen to foster.

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<sup>20</sup> Ibid; Lloyds, through its ‘Black Horse’ brand, are the biggest provider of auto loans in the U.K. outside of the manufacturers themselves, see Marlow (n 11).

<sup>21</sup> For more on the recent cases against S&P and Moody’s see Daniel Cash ‘Why the U.S. Department of Justice Must Act Against Moody’s Corp’ [2016] 37 Business Law Review 6; Daniel Cash ‘The Conclusion of the Department of Justice’s Investigation into Moody’s: Financial Penalties but No Deterrent’ [2017] 38 Business Law Review 6.

Then, in November 2016, in the U.S. Presidential election, political outsider Donald Trump ascending to the highest Office in American politics and swiftly set about developing a pro-market, anti-regulation stance – even taking aim at the Dodd-Frank Wall Street Reform Act in his first week<sup>22</sup>. Now, it is easy to jump to conclusions and suggest that the current sentiment will be continued on both sides of the Atlantic (in addition to a jostling within Europe for financial supremacy post-Brexit<sup>23</sup>) – this we obviously cannot know – but, going on the current trajectory, it is easy to suggest that *increased* regulation of an industry that is generating impressive *short-term* profits is hardly likely to be seen. For this article this is a major concern, and represents the political basis of an environment that has traditionally seen a mass incorporation of wrongdoing, and then subsequent failures across the board. The environment, on the winds of such change, is primed for a positive outcome whereby entrenched sentiments within the world of business, sentiments like the pro-market faith in market actors to do what is best for themselves, and anyone else, can be swept away in favour of responsible business. Yet, the populist movements have been hijacked by those who seek to entrench these principles further, and this article ultimately suggests that this understanding, so close to 2007/08, should serve as a warning to us all that the Financial Crisis of 2007/08 may have only been the start of the difficulties we have faced in recent years.

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<sup>22</sup> Dominic Rushe ‘Trump orders Dodd-Frank review in effort to roll back financial regulation’ [2017] Guardian (Feb 3) <https://www.theguardian.com/us-news/2017/feb/03/trump-dodd-frank-act-executive-order-financial-regulations>.

<sup>23</sup> Lana Clements ‘Desperate France turns on Germany in battle for London’s banking jobs post-brexit’ [2017] Express (Feb 7) <http://www.express.co.uk/finance/city/764286/Paris-Frankfurt-Brexit-battle-London-banking-jobs>.